IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
(HOUSTON DIVISION)

In re ENRON CORPORATION SECURITIES LITIGATION	Civil Action No. H-01-3624 (Consolidated)
This Document Relates To: MARK NEWBY, *et al.*, Individually and On Behalf of All Others Similarly Situated, Plaintiffs, -v.- ENRON CORP., *et al.*, Defendants.	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, -v.- KENNETH L. LAY, *et al.*, Defendants.	

REPLY MEMORANDUM OF LAW OF DEFENDANT CITIGROUP, INC. IN SUPPORT OF ITS MOTION TO DISMISS

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TO THE HONORABLE MELINDA HARMON, UNITED STATES DISTRICT JUDGE:

Defendant Citigroup, Inc. ("Citigroup") submits this reply memorandum of law in support of its motion, pursuant to Federal Rules of Civil Procedure 12(b)(6) and 9(b), to dismiss the Consolidated Complaint for Violation of the Securities Laws (the "complaint"; cited herein as "Cplt. ¶ _").

PRELIMINARY STATEMENT

Plaintiffs' response to Citigroup's motion shares many of the characteristics of their complaint—repetitive, overblown rhetoric; broad-brush, conclusory allegations of fraud; page after page of allegations about the alleged conduct of other defendants, having nothing to do with Citigroup; and a complete absence of specific facts supporting their claims. Plaintiffs plainly hope to persuade the Court—as they announce on the first page of their brief—that, since "everyone knows" this case involves the "worst securities fraud in the history of the United States" (Pl. Mem. at 1), the Court need not concern itself with whether plaintiffs have actually stated a claim against any particular defendant, including Citigroup.

Consistent with this approach, plaintiffs do not rebut—or, in many cases, even respond to—our showing that, under the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), the Supreme Court's decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), and other well-established law, the complaint fails to state a claim against Citigroup and should be dismissed. That is so for at least the following reasons:

First, for all its verbosity, the complaint does not satisfy plaintiffs' obligations under the PSLRA to plead facts—not conclusory allegations—showing that each defendant committed fraud. Setting aside plaintiffs' name-calling, hyperbolic prose, and allegations about other defendants, plaintiffs' claims against Citigroup rest on allegations that Citigroup (i) engaged in derivative transactions, called prepaid swaps, that Enron improperly accounted for as derivative transactions rather than loans; (ii) invested $15 million in a limited partnership associated with Enron, which Enron

allegedly later used to engage in transactions designed to increase its reported revenue and conceal debt; and (iii) participated in the underwriting of the initial public offering of a former Enron subsidiary, whose securities Enron allegedly used in transactions to report non-existent profits. But, as we showed in our opening brief, and as we discuss below, the complaint fails to allege any *facts* showing that Citigroup was responsible for, or even knew about, how Enron accounted for these transactions, or that Citigroup did anything other than engage in routine commercial and investment banking transactions that cannot support a claim for fraud.[1] (*See* pp. 8-15, below.)

Similarly, with respect to statements by Citigroup securities analysts on which plaintiffs base their claims, the complaint fails either to identify the statements that plaintiffs claim are false or misleading, or to state facts explaining why they are false. Plaintiffs devote nearly 25 pages of their brief to repeating, almost verbatim, the allegations of the complaint, but they do not and cannot show that those allegations satisfy the PSLRA pleading requirements. (*See* pp. 15-18, below.)

Second, plaintiffs do not rebut our showing that the complaint fails to allege facts sufficient to create a "strong inference of scienter," as required by the PSLRA. In fact, they hardly try. Thus, plaintiffs do not even cite, much less try to distinguish, this Court's recent decision in *Kurtzman* v. *Compaq*, Civil Action No. H-99-779, slip op. (S.D. Tex. Apr. 1, 2002) (Harmon, J.), addressing this issue. Plaintiffs here,

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[1] Indeed, evidently appreciating that the allegations of the complaint are deficient under the PSLRA, plaintiffs repeatedly rely in their brief on factual assertions about Citigroup that *they have not even pleaded*. Under settled law, plaintiffs cannot cure the defects in their pleading by relying on unsupported factual assertions in their briefs. (See pp. 7-8, below.)

too, rely in large part on assertions of fact that are not pleaded in the complaint (such as the absurd claim that Citigroup was motivated to commit fraud because it allegedly earned "hundreds of millions" or even "billions" of dollars from providing banking services to Enron). Moreover, plaintiffs do not—and cannot—show how the required "strong inference of scienter" can be derived from allegations that assume that Citigroup would engage in patently irrational behavior, such as lending hundreds of millions of dollars to Enron knowing (plaintiffs contend) that it was a money-losing Ponzi scheme. Even in plaintiffs' own view, this is the behavior of a "gambler at a craps table" (Pl. Mem. at 119), not that of a rational economic actor. (*See* pp. 18-26, below.)

Third, in response to our showing that the claims against Citigroup are no more than claims for aiding and abetting that are barred by *Central Bank*, plaintiffs attempt to recharacterize their claims as involving a "scheme" to defraud, and then argue that they are actionable under Rule 10b-5(a) and (c). But plaintiffs' claims against Citigroup are barred by *Central Bank*, not because *Central Bank* precludes any and all conceivable "scheme" claims, but because the complaint *in this case* does not come close to stating such a claim against Citigroup. To state such a claim, as even plaintiffs appear to concede, the complaint must allege facts showing that *each defendant* employed a scheme to defraud. Here, at most, plaintiffs allege no more than that Citigroup did exactly what financial institutions routinely do—provide financing for and/or help to structure transactions—and that Enron itself subsequently misrepresented the true nature of those transactions. Plaintiffs do not allege that Citigroup itself engaged in any manipulative or deceptive conduct on which plaintiffs relied. As numerous courts have held, such allegations (even if pleaded with the requisite specificity that this complaint so

plainly lacks) do not state a claim for primary liability under *any* section of Rule 10b-5. (*See* pp. 26-38, below.)

Finally, plaintiffs concede that they cannot state a claim under Section 11 of the 1933 Act, and they do not respond to our showing that the complaint does not state a claim against Citigroup for "controlling person" liability. Accordingly, those claims also should be dismissed. (*See* p. 39, below.)

Plaintiffs' claims against Citigroup cannot survive the scrutiny mandated by the PSLRA and the precedents established by this and other courts. Citigroup's motion should therefore be granted, and plaintiffs' claims against Citigroup should be dismissed with prejudice.

ARGUMENT

I.

PLAINTIFFS DO NOT REFUTE CITIGROUP'S SHOWING THAT THE COMPLAINT FAILS TO PLEAD WITH PARTICULARITY ANY FRAUDULENT CONDUCT BY CITIGROUP

A. The Vast Majority of the Allegations in The Complaint Have Nothing To Do With Citigroup Or Allege Only That Citigroup Provided Routine Banking Services

Plaintiffs have not responded to the showing in our opening brief that many of the allegations in the complaint that concern Citigroup allege no more than that Citigroup provided ordinary banking services to Enron, such as making commercial loans and underwriting securities. (Citi. Mem. at 9-15.) Instead, plaintiffs simply repeat at length the same insufficient allegations (Pl. Mem. at 28, 45, 100 (bank loans); 20-21, 45-46, 100 (underwriting); 26 (investment banking services)), as though putting the same

deficient allegations in bold-faced type could overcome plaintiffs' failure to plead specific facts.[2] Pouring the "old wine" of the complaint into the "new bottle" of plaintiffs' brief does not improve its quality.[3]

Plaintiffs try to mask their failure to plead specific misconduct by Citigroup by repeating in their brief generalized allegations from the complaint about "the banks" or "Enron's banks," and then simply inserting the words—which do not appear in the complaint—"including Citigroup." (*See, e.g.*, Pl. Mem. at 5, 7-8, 10, 14-15, 17-18, 21-22.) But, under the PSLRA, the complaint cannot rely on broad-brush, "group pleading" allegations, but must alleged *specific* misconduct by *each* defendant. *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 902 n. 45 (S.D. Tex. 2001) (Harmon, J.). Plaintiffs cannot cure their failure to meet this requirement merely by identifying Citigroup after the fact as one of "the banks," without specifying the alleged conduct by it on which plaintiffs' claims rest. Indeed, plaintiffs' persistent efforts, inconsistent with the PSLRA, to engage in "one size fits all" pleading is dramatically underscored by the fact that large portions of their brief addressed to Citigroup's motion to dismiss are

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[2] In particular, plaintiffs have not responded to our showing that their allegations concerning the Enron credit-linked notes and the attempted Enron-Dynegy merger (Citi. Mem. at 14-15) show no wrongdoing by Citigroup.

[3] Plaintiffs also do not respond to our showing that the vast majority of the allegations in the complaint have nothing whatever to do with Citigroup (Citi. Mem. at 7-9). Indeed, as if to underscore our point, plaintiffs devote page after page of their brief to rehashing allegations that are unrelated to Citigroup, including lengthy discussions of the 1997 year end crisis at Enron (Pl. Mem. at 3-4), the JEDI and Chewco transactions (*id.* at 3-4), hedging transactions involving the Raptor partnerships (*id.* at 14-15), and alleged misrepresentations by Enron about its Energy Services business and the Blockbuster transaction (*id.* at 15-17), with no mention of any involvement by Citigroup.

replicated verbatim in plaintiffs' briefs filed in opposition to the motions to dismiss of the other bank defendants.[4]

Equally egregious—and in a tacit admission that the complaint as pleaded is inadequate—plaintiffs repeatedly rely in their brief on purported factual assertions that are *not even pleaded* in the complaint. To take just a few examples:

- In a transparent effort to buttress their deficient allegations of scienter (discussed below, pp. 18-26), plaintiffs assert in their brief that Citigroup earned "hundreds of millions" or even "billions" of dollars from the services it provided to Enron. (Pl. Mem. at 35-36, 38.) The complaint does not—and, consistent with Rule 11, could not—make any such allegation.[5]

- In connection with the allegations relating to New Power, plaintiffs falsely assert in their brief that Citigroup (among other banks) loaned $125 million to a partnership called Hawaii 125-0, while receiving a guarantee from Enron on the loan. (Pl. Mem. at 18, 51.) While the complaint alleges that *other* banks loaned money to Hawaii 125-0, it does not allege that Citigroup was one of the lenders. (Cplt. ¶¶ 42, 679.)

- Plaintiffs assert in their brief (also falsely) that Citigroup loaned $120 million to LJM2 (one of the Enron-affiliated partnerships), and they argue that this purported "fact" somehow supports their claim of wrongdoing by Citigroup with respect to this partnership.

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[4] For example, the entire section entitled "The 97-00 Successes—Enron's Stock Soars"—which contains allegations one would expect to be defendant-specific such as statements allegedly made about Enron—is virtually identical in each of plaintiffs' nine briefs opposing the banks' motions to dismiss, save for the fact that the words "including Citigroup" are replaced by the words "including [bank defendant's name]" in the other eight briefs. (*Compare* Pl. Mem. at 4-10 *with* Pl. Mem. re Bank of America at 5-11; CIBC at 5-10; Credit Suisse First Boston Corporation at 4-10; Deutsche Bank at 4-10; J.P. Morgan Chase at 5-10; Lehman at 5-10; Merrill Lynch at 5-10; Barclays at 4-8.)

[5] As noted in our opening brief (p. 7 n.2), we necessarily accept for purposes of this motion (and only for that purpose) the truth of any well-pleaded allegations in the complaint. We need not and do not accept the truth of the *unpleaded* factual assertions in plaintiffs' brief.

(Pl. Mem. at 97, 101.) Again, however, the complaint contains no allegation about this alleged loan.

- Plaintiffs also purport to rely on quotations from newspaper articles that were published *after* the complaint was filed (and that in most cases have nothing to do with Citigroup in any event). (Pl. Mem. at 1 nn.2-3, 14 n.13, 37 n.25, 53, 108, Ex. 1.)

Plaintiffs' reliance in their brief on factual assertions that are not pleaded in the complaint is patently improper, and these assertions should therefore be disregarded. *Burch v. City of Nacogdoches*, 174 F.3d 615, 617 n.5 (5th Cir. 1999); *Chawla v. Shell Oil Co.*, 75 F. Supp. 2d 626, 653 n.38 (S.D. Tex. 1999) ("[A]llegations in a response to a motion are not sufficient to amend the complaint.").[6]

B. Plaintiffs' Allegations Relating to Prepaid Swaps, LJM2, and New Power Do Not Demonstrate Any Wrongdoing By Citigroup

When plaintiffs' overheated rhetoric, name-calling, lengthy summaries of irrelevant allegations, and unpleaded factual assertions are set aside, plaintiffs' response to Citigroup's motion focuses on three matters: (i) prepaid swap transactions, (ii) Citigroup's investment in the LJM2 partnership, and (iii) the underwriting of the New Power initial public offering. The facts alleged in the complaint relating to these matters, however, show only routine banking activity by Citigroup—not fraud. (Citi. Mem. at 10-13.)

1. Prepaid Swaps

As discussed in our opening brief, while the complaint alleges in conclusory fashion that Enron should have treated the prepaid swap transactions for

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[6] In any event, as we discuss in the next section, these assertions still do not show that Citigroup engaged in any actionable misconduct.

accounting purposes as loans rather than derivatives, it completely fails to allege any facts showing that Citigroup was responsible for Enron's accounting, or even to identify any rule that Enron's accounting allegedly violated. (Citi. Mem. at 11-12.)

Plaintiffs' principal response to this showing is simply to repeat, in a louder tone of voice, pejorative shibboleths, terming these transactions "phony," "disguised," "secret[]," "concealed," and "bogus." (*E.g.*, Pl. Mem. at 19, 37, 38, 43, 45.) But, under the PSLRA and Rule 9(b), such rhetoric does not substitute for facts. Moreover, even the facts that are alleged in the complaint show that—far from being "hid[den]" (Pl. Mem. at 43)—the liabilities created by these transactions *were* recorded, and publicly disclosed, on Enron's balance sheet. (Cplt. ¶¶ 45, 684.) Plaintiffs do not and cannot explain how a company can "hide" a liability by putting it in plain sight on its balance sheet.

Equally important, plaintiffs still cite no accounting or legal rule that Enron account for the prepaid swaps as loans rather than as derivatives. (Citi. Mem. at 11-12.) This failure is no accident; the rules of accounting frequently permit or even require companies to record derivative transactions as price-risk management rather than loans—just as Enron did. That is so even where the transactions have the economic effect of financing.[7] While these accounting rules do not apply directly to the prepaid

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[7] To take just one example: as of the time of the prepaid swap transaction at issue, participants in very similar transactions, called prepaid interest rate swaps, were required by GAAP to record them as derivative transactions (*i.e.*, assets and liabilities from price risk management) rather than as loans. *See* Financial Accounting Standards Board, Derivatives Implementation Group, Statement 133 Implementation Issue No. A9, May 17, 2000 (Affidavit of Richard A. Rosen, sworn to June 21, 2002 ("Rosen Reply Aff."), Ex. A), at 2 (stating that, although a prepaid interest rate swap "involve[s] a lending activity," it "is a derivative instrument" and it "*must* be (. . . continued)

swaps at issue here, they conclusively refute plaintiffs' insinuation that Enron's accounting treatment of these structured financing transaction as a derivative rather than as a loan was so plainly improper that Citigroup—which of course was not Enron's auditor—is charged with knowledge of and active participation in an accounting fraud. (Pl. Mem. at 19, 37-38, 43, 48-50.)[8]

Finally, plaintiffs repeatedly assert that the prepaid swap transactions must somehow have been improper because Citigroup allegedly earned a return on them that was above the interest rate it would have earned on a commercial loan to Enron. (*E.g.*, Pl. Mem. at 19, 37- 38, 45, 50, 100.) This assertion compares apples and oranges. The return on a complex derivatives transaction cannot be compared to the interest rate on a

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(continued . . .)

accounted for as a derivative instrument") (emphasis added). This statement by FASB specifically recognizes the loan-like quality of those transactions; for example, it describes an example of a prepaid interest rate swap as having "principal" and "loan payments." (This rule was later revised, as of October 2001, by Implementation Issue A20 (Rosen Reply Aff., Ex. B), but the new rule was made applicable only prospectively to new transactions entered into after that date, and it specifically provided that "accounting for existing instruments as derivatives should not be changed." (*Id.* at 4.))

[8] Moreover, even if the complaint did sufficiently allege that Enron's accounting treatment violated GAAP, "failure to follow GAAP, without more, does not establish scienter." *Abrams* v. *Baker Hughes Inc.*, No. 01-20514, 2002 WL 1018944, *6 (5th Cir. 2002); *see also Lovelace* v. *Software Spectrum Inc.*, 78 F.3d 1015, 1020-21 (5th Cir. 1996); *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 203-04 (1st Cir. 1999) (GAAP violations can provide evidence of scienter only if pleaded with "sufficient particularity"). Thus, the mere allegation that GAAP was violated, standing alone, is insufficient to raise a strong inference of scienter even against the *auditor*, much less against a counterparty to the transaction such as Citigroup. *In re Sunterra Corp. Sec. Litig.*, No. 6:00-CV-79-ORL-28DAB, 2002 WL 480620, at *20 (M.D. Fla. March 12, 2002) (alleged GAAP violations not sufficient to raise a strong inference of auditor's scienter).

simple bank loan. Moreover, plaintiffs' contention ignores their own allegation that Citigroup hedged these transactions by issuing credit-linked notes, which, as plaintiffs concede, required Citigroup to pay interest to the holders. (Cplt. ¶ 681; Pl. Mem. at 50.) Thus, plaintiffs' exclusive focus in their brief on Citigroup's return on the prepaid swaps ignores one side of what plaintiffs themselves allege was a two-sided transaction.[9]

2. LJM2

Plaintiffs' claims against Citigroup relating to its $15 million passive investment in the LJM2 partnership are equally unsupported by specific facts. In particular, as we showed in our opening brief, the complaint alleges no facts showing that Citigroup—whose investment totaled less than 4% of the money invested in the partnership (Pl. Mem. at 52 n.33)—knew about or was responsible for the details of specific partnership transactions or how Enron accounted for those transactions. (Citi. Mem. 12-13.)

Plaintiffs' repeated assertion that Citigroup "funded" these transactions (*e.g.*, Pl. Mem. at 8-9, 28, 101) is simply another way of saying that Citigroup—like all of the other limited partners—invested in LJM2, but does not show that Citigroup was

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[9] In fact, as plaintiffs are undoubtedly aware, the credit-linked notes carried an interest rate of between 6.5% and 8.75 %—a higher return than the one Citigroup allegedly earned on the prepaid swaps. *See, e.g.,* Offering Memorandum for Enron Credit Linked Notes Trust, 8.00% Enron Credit Linked Notes due 2005, dated August 17, 2000 (Excerpted at Rosen Reply Aff., Ex. C) (indicating an expected return to investors in the credit-linked notes of 8.00%). Plaintiffs also suggest that the issuance of credit-linked notes was somehow evidence of impropriety on Citigroup's part (Pl. Mem. at 49-50), but they do not and cannot refute the showing in our opening brief that that credit-linked notes are a well-recognized and entirely proper derivative instrument commonly used—as in this case—to spread credit risk. (Citi. Mem. at 14-15.)

responsible for any specific transactions by the partnership or for Enron's accounting. Likewise, plaintiffs' repeated assertion that Citigroup "administered" profit distributions and capital calls (Pl. Mem. at 14, 37, 53, 97, 101-02), shows no more than that Citigroup—again, like every other limited partner—knew when and in what amounts the partnership made profit distributions and capital calls. (*See* Citi. Mem. at 12-13.) None of these allegations shows that Citigroup knew the details of the underlying transactions that LJM2 engaged in, much less how *Enron* accounted for those transactions.

Plaintiffs also argue that Citigroup assisted Enron in committing fraud by investing $1.5 million in LJM2 before the partnership was fully formed so that (plaintiffs contend) Enron could engage in transactions with the partnership before year end. (Pl. Mem. at 12, 37, 51-52, 101.) But plaintiffs do not explain why such "pre-funding" is inherently improper or suspicious. Moreover, even if, as plaintiffs allege, this initial investment was made so that LJM2 and Enron could complete certain transactions, plaintiffs point to no facts showing that Citigroup knew the nature of those transactions or how they would be accounted for by Enron. And the allegation that Enron sought to close the transaction before the end of its reporting period "in order to show the transaction[s] on the books during [that period] . . . is not evidence of illegality or fraud." *United States* v. *Grossman*, 117 F.3d 255, 261 (5th Cir. 1997).[10]

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[10] Plaintiffs also claim that the transactions were "quickly unwound" during 2000 (Pl. Mem. at 107), but allege no facts demonstrating that Citigroup knew that these transactions were "unwound," that the unwinding of the transactions was improper, or that Citigroup knew of or recklessly disregarded any alleged impropriety.

Plaintiffs try to bolster their claim relating to this transaction by asserting that Citibank also loaned $120 million to LJM2. (Pl. Mem. at 97, 101.) But, as noted above (pp. 7-8), this allegation is found nowhere in the complaint, and, in any event, is not true. Besides, the mere allegation that Citigroup loaned money to LJM2 does not show that Citigroup was involved in or responsible for Enron's accounting for every transaction engaged in by that entity. *See Insurance Co. of North Amer.* v. *Dealy*, 911 F.2d 1096, 1101 (5th Cir. 1990) (extension of loan to entity allegedly engaged in fraud, without more, does not support claim of aiding and abetting).

Finally, plaintiffs assert that Citigroup should have known that LJM2 was an instrumentality of an Enron fraud because the bank expected to earn high returns through transactions with Enron, or that such high returns amounted to "looting Enron." (Pl. Mem. at 10-11, 14, 37, 53, 101-02, 108.) But plaintiffs do not allege any facts showing that the anticipated returns were abnormally high for private equity funds, which seek high returns but also accept high risk, or that the terms of the investment were the product of something other than arms'-length bargaining by sophisticated parties. And the complaint itself alleges that Enron's Board and senior officers knew and approved of LJM2's transactions. (Cplt. ¶ 23 (alleging that "LJM1 and LJM2 were structured, reviewed and approved" by the Enron Defendants).)[11]

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[11] Plaintiffs' reliance in this regard on an after-the-fact, self-serving claim by Enron CEO Jeffrey Skilling (as quoted third-hand in a newspaper article) that he would have suspected fraud *if he had known* of LJM2's returns (Pl. Mem. at 14 n.13, 37 n.25, 53, 108) can only be termed bizarre. As noted in the text, the complaint itself alleges that Skilling and the other Enron defendants—far from being innocent victims of fraud—were fully aware of and participated in the LJM2 transactions. (*E.g.*, Cplt. ¶ 23; *see also* Plaintiffs' Memorandum of Law in Opposition to Motions To Dismiss Filed by Enron Defendants Buy, et al. at 63-66 (describing allegations in complaint of (. . . continued)

3. New Power IPO

Finally, as we showed in our opening brief, the complaint alleges no more about Citigroup's involvement with New Power (a former Enron subsidiary) than that it was part of the initial public offering underwriting group, and that, *after* the offering, Enron engaged in a transaction with an allegedly controlled partnership involving New Power stock that permitted it improperly to record a $370 million profit. (Cplt. ¶ 679; Citi. Mem. at 10-11.)

Apparently recognizing the flimsiness of their claims, plaintiffs now assert in their brief that, in addition to underwriting the stock offering, Citigroup also participated in a loan of $125 million to Hawaii 125-0, a special purpose entity that Enron allegedly used to record the improper $370 million profit. (Pl. Mem. at 18, 51.) Again, however, plaintiffs' assertion that Citigroup participated in this loan is made up out of whole cloth, and is not pleaded anywhere in the complaint. (*See* p. 7, above.) As discussed above (pp. 7-8), this motion should be decided on the basis of the complaint, not on unpleaded—and entirely false—allegations in plaintiffs' brief. In any event, the mere allegation that Citigroup loaned money to this partnership does not show that Citigroup had any knowledge of the subsequent transactions involving that partnership or

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(continued . . .)

Skilling's knowing participation in Enron's fraudulent scheme, including his "substantial role in the oversight of Enron's relationship with the LJM partnerships"). Moreover, to the extent that plaintiffs are adopting Skilling's claim that he did not know the details of the LJM2 transactions, it only undermines further their claims against Citigroup. If Skilling—the President and CEO of Enron—did not know about the transactions Enron engaged in with LJM2, there is no reason that Citigroup, a mere investor in the partnership, should have known about them.

how Enron accounted for them, and thus does not support a claim of fraud against Citigroup, as discussed above (p. 13).

In sum, the complaint does not allege specific facts showing that Citigroup engaged in fraud in connection with any of these transactions, as required by the PSLRA and Rule 9(b).

C. The Complaint Also Does Not Adequately Allege Specific Misstatements By Citigroup Analysts Or Show Why Such Statements Were Allegedly False

We also showed in our opening brief that the complaint does not state a claim of fraud based on statements made by Citigroup's securities analysts, because it does not specify—again, as required by Rule 9(b) and the PSLRA—either the statements that are allegedly false or the reasons that they are false. (Citi. Mem. at 32.) As we showed, the "laundry list" pleading approach that plaintiffs employ here—purporting to quote from dozens of public statements made by Citigroup and other defendants concerning Enron, and then contrasting those statements with allegations about the "true but concealed facts"—does not satisfy plaintiffs' burden of explaining specifically "what it was about the alleged true facts that made the public statements misleading." *Ruble v. Rural/Metro Corp.*, No. CV-99-0822-PHX, 2001 WL 1772319, at *10 (D. Ariz. Jan. 26, 2001); *see also other cases cited in* Citi. Mem. at 32-33; *ABC Arbitrage Plaintiffs Group* v. *Tchuruk,* No. 01-40645, 2002 WL 975299, at *8 (5th Cir. May 13, 2002) (under the

PSLRA and Rule 9(b), complaint must "specify the statements contended to be fraudulent . . . and explain why [they] were fraudulent").[12]

Plaintiffs do not address, or in most cases even cite, the numerous cases—including decisions of this Court—holding that the pleading approach they follow does not satisfy the PSLRA. *See Kurtzman* v. *Compaq*, Civil Action No. H-99-779, slip. op. (S.D. Tex., Apr. 1, 2002) (Harmon, J.); *Collmer* v. *U.S. Liquids, Inc.*, Civil Action No. H-99-2785, 2001 U.S. Dist. LEXIS 23518 (S.D. Tex. Jan. 23, 2001) (Harmon, J.).[13]

Instead, plaintiffs resort to cutting and pasting from the complaint: for more than 20 pages in their brief, plaintiffs merely repeat from the complaint the same laundry list of statements allegedly made by Citigroup analysts and substantially the same list of allegedly "true but concealed facts," and simply delete the allegations regarding statements made by other defendants. (Pl. Mem. at 77-100.) But plaintiffs' use of word-processing gimmickry does not satisfy their burden of "specify[ing] the reasons why *each*

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[12] Plaintiffs have not responded to our showing that many of the Citigroup analysts' statements cited in the complaint are not actionable because they constitute opinions or forecasts. (Citi. Mem. at 41.) In addition to the cases we cited in our opening brief, see also *Kurtzman* v. *Compaq*, Civil Action No. H-99-779, slip op. at 52 (S.D. Tex. Apr. 1, 2002) (Harmon, J.) "[i]nvestors rely on facts in determining the value of a security, not mere expressions of optimism"); *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 568 (6th Cir. 2001) ("'statements containing simple economic projections, expressions of optimism, and other puffery are insufficient' to attach liability") (quoting *Novak* v. *Kasaks*, 216 F.3d 300, 315 (2d Cir. 2000)).

[13] Plaintiffs inexplicably rely on this Court's decision in *In re Landry's Seafood Rests., Inc. Sec. Litig.*, No. H-99-1948, slip op. (S.D. Tex. Feb. 20, 2001), and assert that the complaint here "is of the same style and format" as the complaint in *Landry's*. (Pl. Mem. at 2.) In *Landry's*, however, the Court *dismissed* plaintiffs' claims against the underwriters for failure to satisfy the pleading requirements of the PSLRA and Rule 9(b). (Plaintiffs assert—incorrectly—that we "basically ignore[d]" *Landry's* in our motion, *id.*; in fact, we cited it repeatedly. *See* Citi. Mem. at 30, 34, 35, 37.)

statement is alleged to have been misleading." *Wenger* v. *Lumisys, Inc.*, 2 F. Supp.2d 1231, 1243 (N.D. Cal. 1998) (cited in Citi. Mem. at 32.) (emphasis in original); *accord*, *ABC Arbitrage*, 2002 WL 975299, at *17 (affirming dismissal of securities fraud complaint on the ground that, among other things, it failed to explain why the alleged "true facts" rendered defendants' statements false).

Plaintiffs also contend that Citigroup's statements in its analysts' reports that it might have ongoing relationships with Enron were false and misleading because they did not specifically disclose its investment in LJM2. (Pl. Mem. at 97.) But Citigroup's analysts' reports, as quoted in plaintiffs' brief, did in fact disclose that Citigroup or its affiliates "may have a position in securities . . . of any company" mentioned in its analysts' reports, that employees of the firm may be a director of such a company, and the firm "may perform or solicit investment banking or other services from any company recommended in this report." Contrary to plaintiffs' assertion, this disclosure did not "conceal" any conflicts of interest that Citigroup might have due to other business dealings with the companies being reported upon; on the contrary, the disclosures expressly reveal that such conflicts may exist.[14]

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[14] Plaintiffs further allege that Citigroup was responsible for allegedly false Enron financial statements included in prospectuses and registration statements for securities that Citigroup underwrote. (Pl. Mem. at 98-99.) As we showed in our opening brief, however, underwriters are not liable under Section 10(b) for alleged misstatements in prospectuses regarding the issuer's financial condition. *See In re VMS Sec. Litig.*, 752 F. Supp. 1373, 1394 & n.18 (N.D. Ill. 1990) (cited in Citi. Mem. at 47 n.14.) Plaintiffs' brief does not address *VMS* or even try to explain why the Court should not follow it.

Finally, plaintiffs have not responded to our showing that the complaint fails to satisfy the PSLRA for the additional reason that it does not identify the facts on which plaintiffs base their belief that Citigroup committed fraud, as the PSLRA requires when the allegations of the complaint are not made on personal knowledge. (Citi. Mem. at 34.) The Fifth Circuit reaffirmed that requirement only last month in *ABC Arbitrage*, holding that, where the allegations of a complaint subject to the PSLRA are not made with personal knowledge, the complaint must "plead with particularity *sufficient* facts to support [plaintiffs'] allegations of false or misleading statements . . . ." *ABC Arbitrage*, 2002 WL 975299, at *11 (emphasis in original).

For these reasons, the complaint should be dismissed for failure to satisfy the requirements of the PSLRA and Rule 9(b).

II.

THE COMPLAINT DOES NOT ALLEGE FACTS GIVING RISE TO A STRONG INFERENCE OF CITIGROUP'S SCIENTER

A. The Complaint Does Not Allege Specific Facts Showing Scienter

We showed in our motion to dismiss that the complaint should be dismissed for the further reason that the conclusory allegations in the complaint do not give rise to a strong inference of Citigroup's scienter, as required by the PSLRA. (Citi. Mem. at 18-25, 28-31, 34-43.) As we showed, the complaint identifies "no names, no meetings, no internal memoranda or documents, no specific conduct or statement" to support plaintiffs' claim that Citigroup knew that Enron was, as plaintiffs allege, a Ponzi scheme and that its financial statements were fraudulent, or that Citigroup acted with intent to defraud. *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1410 (9th Cir. 1996), *cert.*

denied sub nom. Anderson v. *Clow*, 520 U.S. 1103 (1997). These conclusory allegations, without specific facts to support them, are insufficient.[15]

Rather than address or try to distinguish the cases we cited, or point to allegations in the complaint that would satisfy the standard for pleading scienter under the PSLRA, plaintiffs devote most of their response simply to recycling, almost verbatim, the conclusory and insufficient allegations of the complaint. Thus, plaintiffs assert that unidentified Citigroup officials allegedly "constantly interacted" with Enron executives "on an almost daily basis" (Pl. Mem. at 100-01); that its securities analysts issued positive reports about Enron (*id.* at 101); that Citigroup performed due diligence in connection with its role as lender and underwriter (*id.* at 46 n.32, 101, 111-13); and that Citigroup earned fees for providing services to Enron (*id.* at 37-38, 44-45, 118-19). But as the cases cited in our opening brief make clear, such generalized allegations—which could be made about virtually any lender or underwriter in virtually any securities fraud case involving a public company—are insufficient. (*See* Citi. Mem. at 18-21 and cases cited at 34-41.)[16] Indeed, it is indicative of the boilerplate nature of plaintiffs' allegations

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[15] In addition to the cases cited in our opening brief, *see Cronau* v. *Asche*, No. 01 C 50057, 2002 WL 832569 (N.D. Ill. May 1, 2002) (allegations of complaint against auditors did not give rise to strong inference of scienter where plaintiffs failed to plead what information auditors discovered and did not disclose, as well as why the audit procedures were so inadequate as to be reckless).

[16] Plaintiffs appear to suggest that these cases are inapplicable after the repeal of the Glass-Steagell Act, because financial institutions such as Citigroup now engage in both commercial and investment banking activities. (Pl. Mem. at 44 n.31, 111, 113-14.) Plaintiffs offer no support for the proposition that Congress intended, in repealing Glass-Steagel, to weaken the stringent pleading requirements of the PSLRA, enacted only four years earlier. In any event, as discussed in the text, inferences of fraud from such generalized allegations, applicable to virtually all financial services firms, are precisely what the PSLRA does not permit.

concerning Citigroup's scienter that virtually the same unspecific charges are repeated in plaintiffs' briefs in response to the motions to dismiss filed by other investment bank defendants.[17]

Plaintiffs appear to argue that scienter can be presumed because they have alleged that Citigroup engaged in transactions (such as the prepaid swap transactions) that (plaintiffs contend) constituted a "scheme to defraud," and its participation in those transactions was "intentional" rather than the result of "negligence" or "inadvertence." (Pl. Mem. at 102-07.) This argument misses the mark. The PSLRA imposes a burden on plaintiffs of pleading facts creating a strong inference of scienter in all securities fraud cases, whether or not the plaintiffs label the alleged fraud a "scheme" or a "misrepresentation." This requirement cannot be satisfied merely by alleging, in conclusory fashion, that the defendant's conduct was "intentional." *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 886 (S.D. Tex. 2001) (Harmon, J.) (to survive a motion to dismiss, plaintiff must allege facts showing "what actions each Defendant took in furtherance of the alleged scheme and specifically plead what he learned, when he learned it, and how Plaintiffs know what he learned"); *McNamara* v. *Bre-X Minerals Ltd.*, 57 F. Supp. 2d 396, 427 (E.D. Tex. 1999) (dismissing claim against engineering

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[17] *Compare, e.g.,* Pl. Mem. at 100-01 *with* Pl. Mem. re Barclays at 54-55; Bank of America at 93-94; CIBC at 101-02; Credit Suisse First Boston at 97-98; Deutsche Bank at 88-89; J.P. Morgan Chase at 106-07; Lehman at 97; Merrill Lynch at 101-02 (asserting nearly identical, boilerplate allegations of scienter against each of the defendant banks).

firm based on alleged participation in fraudulent scheme for, *inter alia,* failure to allege sufficient facts showing scienter).[18]

Plaintiffs' reliance on *In re Livent, Inc. Noteholders Sec. Litig.*, 174 F. Supp. 2d 144 (S.D.N.Y. 2001) is misplaced. (Pl. Mem. at 109-111.) In that case, a bank, CIBC, made a $4.6 million payment to the issuer, Livent, which Livent reported as a "non-refundable fee," while simultaneously entering into a secret side letter whereby Livent agreed to repurchase the same advance in six months with interest. *In re Livent,*

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[18] Plaintiffs' long-winded argument that participants in a scheme to defraud can be held liable for all of the acts involved in the scheme (Pl. Mem. at 103-06) is entirely beside the point. The issue is not whether Citigroup could ultimately be held liable for the acts of others, but whether the facts alleged in the complaint adequately show that Citigroup was a participant in a fraudulent scheme in the first place.

Similarly, plaintiffs' argument that Citigroup can be held liable under the "collective knowledge" doctrine (Pl. Mem. at 114-117) has no bearing here. Under that doctrine, knowledge held by employees of a defendant corporation may in some circumstances be imputed to the corporation. The predicate for applying that doctrine, however, is that *some employee of the corporate defendant* be shown to have culpable knowledge. Here, as discussed in the opening brief (pp. 18-21) and in the text (pp. 18-19), the complaint does not identify a single Citigroup employee with allegedly culpable knowledge or intent. Accordingly, the "collective knowledge" doctrine is inapplicable.

Moreover, contrary to plaintiffs' assertion that any knowledge held by anyone within Citigroup is automatically attributable to its securities analysts (Pl. Mem. at 114), the courts have repeatedly held that Rule 9(b) prevents imputation of knowledge to securities analysts absent specifically pleaded facts. *See Abbell Credit Corp.* v. *Bank of America Corp.*, No. 01 C2227, 2002 WL 335320, at *4-5 (N.D. Ill. Mar. 1, 2002) (declining to infer scienter from a lender to its brokerage subsidiary when the plaintiffs' complaint "imputes [the lender's] knowledge to its subsidiary without providing any concrete factual basis for doing so"); *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1121-22 (D. Nev. 1998) (conclusory allegations insufficient to raise inference of underwriter defendant's knowledge of misrepresentations in prospectus or in securities analysts' reports); *In re Oak Tech. Sec. Litig.*, No. 96-20552 SW, 1997 WL 448168, at *14 (N.D. Cal. Aug., 1, 1997) (same).

174 F. Supp. 2d at 147. CIBC then publicly marketed Livent securities, the proceeds of which were intended to be used to pay down Livent's debt to CIBC. *Id.* The court held that these allegations supported an inference of fraudulent intent on the part of CIBC under the PSLRA.

There are no remotely comparable allegations about Citigroup here. Plaintiffs have not alleged that Citigroup and Enron entered into any secret, undisclosed transactions. On the contrary, as discussed above, the transactions at issue were disclosed, as the complaint admits. (Cplt. ¶¶ 67, 684.) And, in sharp contrast to the alleged behavior of CIBC—which was selling securities to the public in order to *reduce* its outstanding loans to Livent—plaintiffs here allege that Citigroup and the other bank defendants were *increasing* their exposure to Enron by billions of dollars even as Enron's business was unraveling. (Cplt. ¶ 680; Citi. Mem. at 22-25.) That is precisely the opposite of what a rational lender would do if it knew that the borrower's business was about to collapse, and it further underscores plaintiffs' failure to plead scienter with particularity. Finally, as discussed above (pp. 18-19), plaintiffs' claims against Citigroup—like the allegations against the other bank defendants in *Livent*, and in contrast to the specific allegations of fraud alleged against CIBC—rest on the sort of "vague, conclusory, [and] universally applicable" allegations that the courts have consistently held to be insufficient. *In re Livent*, 174 F. Supp. 2d at 152.

McNamara v. *Bre-X Minerals, Ltd.*, 197 F. Supp. 2d 622 (E.D. Tex. 2001) (discussed in our opening brief, *see* Citi. Mem. at 40-41), on which plaintiffs also rely, likewise does not support their position. (Pl. Mem. at 74.) As discussed in our opening brief, the court there initially *dismissed* allegations against defendant J.P. Morgan on the

ground that plaintiffs' allegations that Morgan "was motivated by its desire to ingratiate itself with Bre-X, to collect professional fees for its advisory position, and to enhance its business reputation . . . [were] insufficient to satisfy the motive test." *Id.* at 679. Only after the plaintiffs there amended their complaint to plead *specific facts* supporting their claim of scienter as to one defendant did the Court uphold the plaintiffs' claim against that defendant (while dismissing the claims against another securities analyst). Among other facts alleged that the *Bre-X* court found satisfied the requirement of pleading scienter, the plaintiffs there (i) identified by name the specific securities analyst who allegedly had knowledge of the issuer's fraud; (ii) specified the specific internal Bre-X documents, unavailable to other analysts, that showed that the issuers' claim to have located large gold deposits might be false; (iii) specified the time and nature of the analysts' visits to the mine site and what he saw there; (iv) alleged that the analyst discussed specific "red flags" in a specific conference call; and (v) alleged that the analyst held over a million shares of Bre-X stock for his own account. *Id.* at 680-82.[19] There is no similar detail regarding Citigroup in this case.[20]

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[19] In that same opinion, the court noted that it had dismissed allegations against another securities analyst because the plaintiffs failed to adequately plead "when and how" the defendant learned of certain tests that would have revealed the alleged fraud. *Bre-X*, 197 F. Supp. 2d at 693-94.

[20] The remaining cases on which plaintiff rely are equally unpersuasive. (Pl. Mem. at 71-74.) The court in *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558, 1578 (S.D. Fla. 1993), *reconsideration granted in part*, 894 F. Supp. 437 (1995), a pre-PSLRA case, applied a standard for pleading scienter—whether the plaintiffs' allegations of scienter had a "factual basis"—that is far less stringent than the PSLRA standard applicable here. *Flecker v. Hollywood Entm't Corp.*, No. Civ. 95-1926-MA (LEAD), 1997 WL 269488 (D. Or. Feb. 12, 1997), was a summary judgment case, and did not address the pleading requirements at issue on this motion.

(. . . continued)

B. Plaintiffs' Claim of Scienter Is Further Weakened By The Irrational Nature of the Conduct Plaintiffs Ascribe To Citigroup

We also showed in our opening brief that any inference of scienter is especially weak here, because the scheme alleged by plaintiffs assumes that Citigroup acted irrationally by lending hundreds of millions of dollars to a company it allegedly knew was a Ponzi scheme. (*See* Citi. Mem. at 22-25, 42-43.) As the courts have recognized:

> Ponzi schemes are doomed to collapse, and while an individual may be able to escape with the proceeds of a Ponzi scheme, a bank cannot. Thus, participation in the scheme would not appear to be in the banks' economic interest. The fact that the banks stood to gain by . . . earning fees . . . does not support an inference of fraudulent intent on the part of the banks.

Schmidt v. *Fleet Bank*, 96 Civ. 5030, 1998 WL 47827, at *6 (S.D.N.Y., Feb. 4, 1998) (internal citations omitted); *see also Ray* v. *General Motors Acceptance Corp.*, No. CV-92-5043, 1995 WL 151852, at *5 (E.D.N.Y. Mar. 28, 1995) (recognizing that lender would not have motive to lend money to alleged Ponzi scheme because it "could not hope

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(continued . . .)

Finally, *Murphy v. Hollywood Entm't Corp.*, No. Civ. 95-1926-MA, 1996 WL 393662 (D. Or. May 9, 1996) (Pl. Mem. at 71), was a pre-PSLRA case. To the extent that the court there held that scienter was adequately pleaded against an underwriter based upon allegations that the defendant had a "close association" with and "constant access" to the issuer, and engaged in unspecified due diligence activities, *id.* at *6, it is inconsistent with the law in this Circuit after the PSLRA under *Nathenson* and this Court's decisions in *Kurtzman*, *BMC Software*, and *Landry's Seafood*, which have made clear that such conclusory allegations do not satisfy the pleading requirements of the PSLRA.

to recoup even a fraction of [its loans] through the continuation of the alleged 'Ponzi scheme.'").

Plaintiffs respond to this showing principally by characterizing Citigroup's revenues from its dealings with Enron as "huge," but this conclusory characterization does not explain why Citigroup would have risked losses that were orders of magnitude larger than any conceivable banking fees and interest it might earn. Thus, for example, plaintiffs assert that Citigroup was motivated to keep Enron afloat in order to earn above-market returns on its $15 million investment in LJM2. (Pl. Mem. at 117-19.) But no rational investor would expose itself to the risk of losing hundreds of millions of dollars to protect such a relatively minuscule investment.[21] Nor does the complaint allege any facts showing that Citigroup's fees from underwriting Enron securities or the interest it earned on lending money to Enron came close to the vast sums it had at risk if Enron failed. Finally, as noted above, plaintiffs' repeated assertion that Citigroup earned "hundreds of millions" or "billions" of dollars from its business with Enron is not and could not be alleged in the complaint. (*See* p. 7, above.)

In addition to the vast financial exposure, plaintiffs' theory of scienter also assumes that Citigroup and virtually every other major banking institution would be willing to jeopardize its reputation and risk substantial liability, all to protect its fees and a relatively small investment. As the courts have repeatedly recognized, no rational economic actor would endanger its professional standing and the viability of its entire

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[21] Even if, as plaintiffs contend (Pl. Mem. at 37 n.25), Citigroup expected to earn 50% annual returns from LJM2, such a return on a $15 million investment would be $7.5 million a year, a small fraction of the amounts Citigroup had at risk if Enron failed.

multi-faceted business by a participating in a high-profile Ponzi scheme that was fraught with legal and regulatory risk. *E.g.*, *Melder* v. *Morris*, 27 F.3d 1097, 1104 n.10 (5th Cir. 1994) (refusing to "indulge" plaintiffs' allegations that underwriter defendants would risk their professional reputation for profit on two securities offerings); *In re WRT Energy Sec. Litig.*, Nos. 96 Civ. 3610 (JFK), 96 Civ. 3611 (JFK), 1997 WL 576023, *12 (S.D.N.Y. Sept. 15, 1997) ("[I]t would not seem to be in the Underwriter Defendants' best financial interest to risk their reputations in order to generate fees likely amounting to only a small percentage of their annual revenues.").

Indeed, plaintiffs themselves appear to recognize the irrationality of the behavior they attribute to Citigroup. According to plaintiffs, Citigroup was "[l]ike a gambler at the craps table who has a long run of good luck, but keeps doubling up" after each successful roll until "he finally rolls a seven." (Pl. Mem. at 119.) This is the behavior of a gambling addict, not of a rational economic actor. If, as plaintiffs allege, Citigroup knew that Enron was a fraud and lending it money was a gamble, it would have walked away from the table while it was ahead, instead of continuing to roll the dice on hundreds of millions of dollars.

III.

PLAINTIFFS' CLAIMS AGAINST CITIGROUP ARE BARRED UNDER *CENTRAL BANK*

A. Plaintiffs Have Not Refuted Our Showing That Their Claims Are In Essence For Aiding And Abetting And Are Therefore Precluded By *Central Bank*

In our opening brief, we showed that plaintiffs' principal claims against Citigroup also are barred by the Supreme Court's decision in *Central Bank of Denver,*

N.A. v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), because those claims do nothing more than charge Citigroup with aiding and abetting Enron's alleged violations of Section 10(b) and Rule 10b-5, and the Supreme Court held in *Central Bank* that private plaintiffs may not sue for aiding and abetting a Section 10(b) violation. (Citi. Mem. at 44-50.) In particular, the complaint does not allege that Citigroup participated in any way in the preparation of Enron's financial statements or other public statements.[22] Thus, the complaint does not satisfy either the "bright line" test adopted by the Second, Tenth, and Eleventh Circuits or the "substantial participation" test adopted by the Ninth Circuit. (*Id.*)[23]

Plaintiffs implicitly concede that Citigroup did not participate in the preparation of allegedly fraudulent financial statements by Enron (or any other alleged misrepresentations by Enron about its business). Instead, plaintiffs argue that the complaint states a claim against Citigroup for primary violations of Section 10(b) even if the bank did not itself make or participate in making any fraudulent misrepresentations. They argue that Citigroup can be held primarily liable solely for conduct—participating in transactions involving Enron (such as LJM2 and the prepaid swaps)—because, they

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[22] To the extent that plaintiffs' claims against Citigroup are based on alleged misstatements made by its analysts, we do not dispute, for purposes of this motion to dismiss only, that their claims are not barred by *Central Bank*. Those claims should, however, be dismissed on the entirely separate grounds set forth in Point I, above. Thus, we do not address in this section of our reply brief plaintiffs' claims relating to Citigroup's analyst statements.

[23] Consistent with this conclusion, the *Tittle* plaintiffs have also argued that the claims here against Citigroup are not actionable under *Central Bank*. (Tittle Plaintiffs' Memorandum in Opposition to Defendants' Motions to Dismiss Civil RICO Claims at 91-94, 96-97.)

contend, the transactions were inherently manipulative or deceptive, and thus constituted a "scheme" or "course of business" to defraud giving rise to liability under sections (a) and (c) of Rule 10b-5. (Pl. Mem. at 31-41, 54-76.)

To state a claim under Rule 10b-5(a) or (c), however, it is not enough to allege that the defendant played some role in the alleged scheme to defraud. Rather, as the Ninth Circuit held in *Cooper* v. *Pickett*, 137 F.3d 616 (9th Cir. 1997) (as amended Jan. 30, 1998)—a case on which plaintiffs themselves rely (Pl. Mem. at 33, 38, 57-58, 69, 70-71)—the plaintiff must allege specific facts showing that "*each defendant* committed a manipulative or deceptive act in furtherance of the scheme." *Cooper*, 137 F.3d. at 624 (emphasis added); *accord Dinsmore* v. *Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 843 (2d Cir. 1998) (requirements for primary liability "may not be satisfied based solely on one's participation in a conspiracy in which *other parties* have committed a primary violation"; emphasis in original). Thus, to state a claim based upon an alleged "scheme," the complaint must allege facts showing that Citigroup itself engaged in conduct that was inherently manipulative or deceptive. *See Central Bank*, 511 U.S. at 177 ("We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.")[24]

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[24] *See also Pin* v. *Texaco, Inc.*, 793 F.2d 1448, 1451 (5th Cir. 1986) ("In order to state a cause of action under § 10(b), a plaintiff must plead *facts* that would amount to manipulation or deceptive conduct proscribed by that section and Rule 10b-5."; emphasis in the original). For that reason (and as plaintiffs appear to concede, Pl. Mem. at 104 n.57), *Central Bank* precludes private claims for conspiracy to violate Section 10(b). *E.g.*, *Cooper*, 137 F.3d at 624; *Dinsmore*, 135 F.3d at 841, 842-43.

The courts have recognized only limited categories of conduct that are inherently manipulative or deceptive under Rule 10b-5. These include manipulative "practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity," *Santa Fe Indus.* v. *Green*, 430 U.S. 462, 476 (1977); misstatements or omissions, *Cooper*, 137 F.3d at 624-25; insider trading, *United States* v. *O'Hagan*, 521 U.S. 642, 650-53 (1997); and misappropriation of securities, *S.E.C.* v. *Zandford*, 122 S. Ct. 1899 (2002).

Applying these principles, the courts have repeatedly rejected efforts by plaintiffs to avoid *Central Bank* by recharacterizing aiding and abetting claims as "schemes." *E.g.*, *In re Oak Tech. Sec. Litig.*, No. 96-20552 SW, 1997 WL 448168, at *10 (N.D. Cal. Aug. 1, 1997) (dismissing claim where "Plaintiffs' 'scheme' allegations are no more than a thinly disguised attempt to avoid the impact of the *Central Bank* decision"); *Stack* v. *Lobo*, Civ. No. 95-20049 SW, 1995 WL 241448, at *10 (N.D. Cal. Apr. 20, 1995) (same); *In re Gupta Corp. Sec. Litig.*, 900 F. Supp. 1217, 1243-44 (N.D. Cal. 1994) (rejecting plaintiffs' effort to characterize non-actionable conspiracy claim as claim based upon a "scheme").

The facts alleged in the complaint do not support a claim against Citigroup under Rule 10b-5(a) or (c) under these standards.[25] The complaint alleges—at most—

[25] Plaintiffs inexplicably assert that Citigroup "claims that *Central Bank* eliminated fraudulent scheme or course of business liability" (Pl. Mem. at 61), and that Citigroup "offers up numerous rationales as to why *Central Bank* eliminated Rule 10b-5(a) and (c) liability." (*Id.* at 62.) This issue is a straw man of plaintiffs' own devising; Citigroup has not made any such claim. As we show in the text, plaintiffs' claims against Citigroup fail, not because *Central Bank* abolished liability under Rule 10b-5(a) or (c), but because the complaint does not state a claim against Citigroup under those sections of the rule.

that Enron consistently misrepresented its financial and business results in its financial statements and elsewhere and that the other defendants were involved in the transactions that were later misrepresented by Enron. Indeed, the complaint devotes more than 140 pages (Cplt. at 106-253) to reciting more than one hundred alleged misrepresentations made about Enron's business and finances before and during the Class Period. While the complaint at times characterizes those facts, in conclusory and boilerplate fashion, as constituting a "scheme to defraud" or a "course of business that operated as a fraud or a deceit" (*e.g.*, Cplt. ¶ 2), plaintiffs do not and cannot allege that they were deceived by the *transactions* involving Citigroup, but only by Enron's alleged *misrepresentations* about those transactions.

To be specific, the complaint alleges the following with respect to the transactions in which Citigroup played a role:

- *Prepaid Swaps*: The fundamental allegation of the complaint is that Enron and Citigroup entered into the prepaid swaps to permit Enron to obtain financing without reporting it as debt. Thus, the complaint alleges that the purpose of the prepaid swaps was "to disguise what were, in reality, loans," and that "Enron's balance sheet misrepresented these transactions" as liabilities and assets from price risk management rather than loans. (Cplt. ¶ 684.) Plaintiffs thus characterize these transactions as "hidden/disguised loans." (*Id.* at 29.) The complaint further alleges that Citigroup and Enron structured the transactions as swaps rather than as loans to disguise the scope of Enron's borrowings and thus to conceal Enron's weakened financial condition. (*Id.* ¶ 46; *see also* Pl. Mem. at 19.) As these allegations make clear, it was Enron's reporting of these transactions as derivatives rather than loans—and not the making of the transactions themselves—that constituted the alleged fraud; indeed, the complaint characterizes the transactions as "Hidden/Disguised Loans" (Cplt. at 29).

- *LJM2*: The heart of plaintiffs' allegations about Citigroup's investment in LJM2 similarly relates to alleged misrepresentations by Enron, and not to any inherent manipulation or deception in the

transactions themselves. The complaint alleges that Enron "improperly accounted for the LJM partnerships and its transactions with those entities" (Cplt. ¶ 448), that the transactions between LJM2 and Enron "misstated Enron's financial statements" (*id.* ¶ 462), that the purpose of these transactions was to enable Enron to improperly report income and conceal debt (*id.* ¶¶ 466-495), and that transactions between the LJM partnerships and Enron or its affiliates were effected close to the end of financial reporting periods "to artificially boost reported results" to meet Enron's revenue projections (*id.* ¶ 32). The complaint thus characterizes LJM2 as a "manipulative device[] *used to falsify Enron's financial results*" (*id.* ¶ 24; emphasis added), and that Citigroup and other bank defendants "pre-funded" LJM2 in 1999 to enable Enron to "avoid[] reporting a very bad 4thQ 99" (*id.* ¶ 28). Thus, again, the complaint alleges, not that these transactions (much less Citigroup's initial investment in LJM2) were inherently manipulative or deceptive, but that Enron engaged in fraud by improperly *reporting* the transactions between itself or its affiliates and the partnerships.

- *New Power*: Plaintiffs characterize the New Power IPO as "[a]nother example of how Enron and CitiGroup *falsified Enron's reported results* . . . ." (Pl. Mem. at 17; emphasis added.) They contend that the transactions involving New Power enabled Enron to report a "phony profit" in the fourth quarter of 2000, and that Enron later "concealed" a huge loss early in 2001 when New Power's stock fell. (*Id.* at 18; *see also* Cplt. ¶ 42.) Again, therefore, the heart of plaintiffs' claim is that Enron committed fraud by *misrepresenting* the true nature of the transactions—not that the transactions themselves were inherently manipulative or deceptive.

In short, had Enron properly reported these transactions, there would have been no fraud.

The courts have consistently held that allegations that a financial institution helped structure or finance a transaction that is later misrepresented or improperly disclosed by the financial institution's client or counter-party does not give rise to primary liability under Rule 10b-5. In *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26 (D. Mass. 1994), for example, plaintiffs alleged that they had

suffered losses as a result of materially misleading statements of sales revenue by the issuer. *Id.* at 26-27. Plaintiffs also asserted claims against the issuer's outsider adviser based, in part, upon its having structured many of the transactions for which revenue was improperly reported. The court dismissed, in relevant part, plaintiffs' claims against the advisor, holding that the structuring of the transactions did not constitute actionable conduct under Section 10(b) or Rule 10b-5. *Id.* at 28 n.1. *See also, e.g., Primavera Familienstiftung* v. *Askin*, No. 95 Civ. 8905 (RWS), 1996 WL 494904, at *6-*7 (S.D.N.Y. Aug. 30, 1996) (no claim for primary violation under Rule 10b-5(a) or (c) was stated where complaint alleged that defendant broker-dealers had, among other things, "created, supplied, and financed the purchases of and then sold 'toxic waste' securities" to investment funds that allegedly resold interests in them to plaintiffs), *reconsideration in part granted on other grounds*, 1996 WL 580917 (Oct. 9, 1996).[26]

The result in these cases follows directly from the reasoning of the Supreme Court in *Central Bank*. The Court held that permitting a plaintiff to sue for aiding and abetting would undermine the requirement of reliance in private actions under

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[26] *See also Scone Invs., L.P.* v. *American Third Mkt. Corp.*, 97 Civ. 3802 (SAS), 1998 WL 205338, at *7-*9 (S.D.N.Y. Apr. 28, 1998) (no claim for primary liability was stated against bank that allegedly financed principal defendants' stock purchases and pressured them to liquidate holdings of manipulated stocks to pay down bank's credit line; while bank's conduct "facilitated—and even precipitated" the misrepresentation, such conduct amounts to aiding and abetting, not primary liability); *Kahn* v. *Chase Manhattan Bank, N.A.*, 90 Civ. 2824 (LMM), 1995 WL 491067, at *2 (S.D.N.Y. Aug. 17, 1995) (no claim for primary violation was stated against bank that allegedly permitted principal violator to cash checks with forged endorsements and to make unauthorized use of bank accounts, because such conduct is not itself manipulative or deceptive), *appeal dismissed*, 91 F.3d 385 (2d Cir. 1996).

Section 10(b) by permitting suit where the plaintiff could not show reliance on the defendant's statements or actions. The Court stated:

> Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions. . . . Allowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on [Rule] 10b-5 recovery mandated by our earlier cases.

Central Bank, 511 U.S. at 180; s*ee also Scone Invs.*, 1998 WL 205338, at *9 (permitting suit against defendant that financed allegedly fraudulent transactions "would impose liability for conduct on which the plaintiffs did not rely," in violation of *Central Bank*).

Here, the conduct by Citigroup alleged in the complaint involves—at most—financing or structuring transactions that Enron allegedly used to misrepresent its financial status. Plaintiffs do not and cannot allege that they relied on any act by Citigroup, but only on Enron's (and other defendants') alleged misrepresentations concerning the transactions in which Citigroup allegedly engaged. Under *Central Bank*, these claims are precluded.

The cases on which plaintiffs rely are inapposite. Most of those cases involve a defendant that had itself made or participated in a misrepresentation or actionable omission, and are therefore inapplicable for the reasons given in our opening brief (pp. 44-50).[27] Indeed, the court in *Murphy* v. *Hollywood Entm't Corp.*, No. Civ. 95-

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[27] *See, e.g., Murphy* v. *Hollywood Entm't Corp.*, No. Civ. 95-1926-MA (LEAD), 1996 WL 393662, at *6 (D. Or. May 9, 1996) (cited in Pl. Mem. at 38, 71, 98) (in a pre-PSLRA case, denying motion to dismiss where complaint sufficiently alleged that defendants participated in making alleged misrepresentations under the Ninth Circuit "substantial participation" test); *Flecker* v. *Hollywood Entm't Corp.*, No. Civ. 95-1926-MA (LEAD), 1997 WL 269488, at *8-*9 (D. Or. Feb. 12, 1997) (cited in Pl. (. . . continued)

1926-MA (LEAD), 1996 WL 393662 (D. Or. May 9, 1996) (cited in Pl. Mem. at 38, 71, 98) expressly rejected the very theory of scheme liability that plaintiffs advance here:

> I do agree with the Underwriter defendants that mere participation in a "scheme" that includes the issuance of false financial statements . . . would fail under *Central Bank*. Plaintiffs must prove what they have alleged in their complaint and other responding papers—that is that the underwriters were direct, knowing participants in the drafting of documents which included material misstatements and/or omissions.

Id. at *6 n.10.[28]

The Ninth Circuit's decision in *Cooper* likewise involved alleged misrepresentations that—in contrast to what is alleged here—were made by all of the defendants. Plaintiff there alleged that defendant Merisel gave false information about its

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(continued . . .)

Mem. at 38, 71, 72) (denying summary judgment motion on same rationale); *In re Livent, Inc. Noteholders Sec. Litig.*, 174 F. Supp. 2d 144, 154 (S.D.N.Y. 2001) (cited in Pl. Mem. at 38, 72-73, 109-11 ("The Court finds that these allegations are sufficient to state a claim that CIBC *engaged in material misrepresentation or omission* of facts in violation of § 10(b)"; emphasis added); *McNamara* v. *Bre-X-Minerals Ltd.*, 197 F. Supp. 2d 622, 683 (E.D. Tex. 2001) (cited in Pl. Mem. at 39, 74) (concluding that plaintiffs "have adequately pleaded a [Rule] 10b-5 misrepresentation" and omission); *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558, 1561 (S.D. Fla. 1993) ("Plaintiffs accuse all Defendants of making materially misleading statements or omissions"), *reconsideration granted in part*, 894 F. Supp. 437 (1995) (cited in Pl. Mem. at 39, 73).

[28] To the extent that the court in *Adam* v. *Silicon Valley Bancshares*, 884 F. Supp. 1398 (N.D. Cal. 1995), denied defendant Deloitte & Touche's motion to dismiss based upon its alleged participation in statements made by the defendant issuer, *id.* at 1401, it is also a misrepresentation case, not a scheme or course of business case. To the extent *Adam* may be read as denying the motion based upon D&T's "participation in a scheme to defraud," without requiring plaintiffs to allege an identifiable manipulative or deceptive act by D&T, *id.* at 1400-01, it is inconsistent with the Ninth Circuit's subsequent decision in *Cooper*, and is therefore no longer good law.

business to analysts employed by the defendant banks, with the intent that it would be disseminated into the market, and that the analysts, knowing that the information was false, nevertheless included that information in their reports. The complaint further alleged that Merisel distributed the analysts' reports to potential investors. *Cooper*, 137 F.3d at 620-21. In those circumstances, the Ninth Circuit rejected Merisel's argument that it could not be held liable under *Central Bank*, holding that it could be liable as a primary violator "for its own false statements to the analysts." *Id.* at 624.

Other cases on which plaintiffs rely, while not involving misrepresentations by the secondary defendant, nevertheless involve acts committed by that defendant that are inherently fraudulent or manipulative. *See S.E.C.* v. *U.S. Envtl., Inc.*, 155 F.3d 107 (2d Cir. 1998) (cited in Pl. Mem. at 39, 74) (holding defendants primarily liable for engaging in stock manipulation, including wash sales and matched orders); *S.E.C.* v. *Zandford*, 122 S. Ct. 1899 (2002) (cited in Pl. Mem. at 34-35, 60) (defendant broker-dealer held liable for inducing clients to open discretionary trading account and then misappropriating securities from that account for his own benefit).[29]

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[29] *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960 (C.D. Cal. 1994) (cited in Pl. Mem. at 58, 66-67 n.44, 103, 104), held that the accountant defendant, Ernst & Young, committed a deceptive act by preparing or substantially participating in preparing false financial statements for the issuer, and thus is also distinguishable from this case. Here, Citigroup is not alleged to have participated in Enron's preparation of its financial statements. To the extent that *ZZZZ Best* held that E&Y could be held liable for mere "involvement" in a scheme to defraud by the issuer, *id.* at 972, it is inconsistent with the Ninth Circuit's later decision in *Cooper* and should be disregarded.

Plaintiffs also rely upon *S.E.C.* v. *First Jersey Sec., Inc.*, 101 F.3d 1450 (2d Cir. 1996), but that case does not apply here. As the Second Circuit later held in *Wright* v. *Ernst & Young*, 152 F.3d 169 (2d Cir. 1998), the court in *First Jersey* held only that the defendant, the president, chief executive, and sole owner of a securities firm, was

(. . . continued)

Plaintiffs seek to trivialize *Central Bank* by asserting that the plaintiffs there lost only because they did not *label* their claim as one for primary liability. (*See* Pl. Mem. at 59 (asserting that "because the *Central Bank* plaintiffs *pursued a theory of recovery* which found no support in the text of either the statute or the rule, they lost"; emphasis added).) But, as the opinion in that case makes clear, the Court's refusal to permit a claim for aiding and abetting rested on the express language of Section 10(b) and fundamental policies of the securities laws—not the labels that plaintiffs put on their claims. *See Central Bank*, 511 U.S. at 173-78, 188-89; Citi. Mem. at 45. *Cf. In re Ross Sys. Sec. Litig.*, No. C-94-0017-DLJ, 1994 WL 583114, at *4 (N.D. Cal. July 21, 1994) (plaintiffs may not avoid *Central Bank* by labeling claim one for conspiracy rather than aiding and abetting because rationale of *Central Bank* precludes implied cause of action for secondary violation of section 10(b)).

To permit plaintiffs' claims against Citigroup to stand would gravely undermine these principles. Citigroup is not alleged to be responsible for Enron's misrepresentations or to have engaged in any manipulative or deceptive conduct on which plaintiffs relied. While plaintiffs may wish for Congress to overturn *Central Bank*

(continued . . .)

primarily liable for "direct[ing] his employees to make false and misleading statements to customers." *Id.* at 176. In *Wright*, by contrast, the court held that "secondary actors" such as the issuer's accountants could not be held primarily liable even though they allegedly knew about and participated in the issuer's fraud. *Id.* at 175-76. Citigroup is an even more remote actor, alleged by plaintiffs to have helped Enron carry out its scheme by structuring transactions, lending money, and investing in a limited partnership. Such allegations of knowledge and assistance are insufficient to state a claim against a secondary actor after *Wright*.

(Pl. Mem. at 41), *Central Bank* is the law, and under it plaintiffs' claims against Citigroup fail.

B. The Amicus Briefs Submitted By The SEC and the States Do Not Aid Plaintiffs' Case

Finally, we address briefly the amicus curiae memoranda submitted by the S.E.C. and the Attorneys General of various states, neither of which offers a persuasive reason for the Court to deny Citigroup's motion. Indeed, the S.E.C. expressly "takes no position on whether the motions to dismiss should be granted or denied" (S.E.C. Mem. at 2), and further recognizes that "the application of the appropriate legal principles could have different effects for different defendants." (*Id.* at 4 n.4.)

Addressing *Central Bank*, the S.E.C. asserts that primary liability should be found when the defendant, "acting alone or with others, creates a misrepresentation . . . ." (S.E.C. Amicus Brief in *Klein* v. *Boyd*, at 14, attached to SEC Mem. as Att. 1.) It emphasizes that this standard does not permit claims based on "lesser degrees of involvement" that are "not actionable [under] *Central Bank*," including allegations of "assisting," "participating in," or "complicity" in an alleged fraud. (*Id.* at 15-16 (approvingly quoting *Shapiro* v. *Cantor*, 123 F.3d 717, 720 (2d Cir. 1997).) Under the S.E.C.'s proposed standard, no claim for primary liability is asserted here against Citigroup based upon any of its transactions with Enron or any of the Enron-affiliated partnerships, because, as discussed above (pp. 5-18), the complaint here does not allege that Citigroup played any role in Enron's preparation of its financial statements or in the preparation by Enron of any misrepresentations.

The S.E.C.'s amicus briefs in the *O'Hagan* and *Bryan* case (S.E.C. Mem., Atts. 2 and 3) also do not support plaintiffs' position here. In both cases, the S.E.C. contends that misappropriating material inside information by trading on that information for personal benefit can constitute a "scheme to defraud" under Rule 10b-5(a) or (c). No such allegations are at issue here with regard to Citigroup.

The memorandum submitted by certain state attorneys general simply urges that *every* defendant's motion be denied, without bothering to analyze any specific factual allegation against any specific defendant. Instead, their brief simply repeats, in conclusory fashion and frequently verbatim, the arguments made by the plaintiffs, which fail for the reasons discussed above. (*Cf., e.g.*, State AG Mem. at 5-6 *with* Pl. Mem. at 61 n.37; State AG Mem. at 16-17 & n.9 *with* Pl. Mem. at 64 & n.42; State AG Mem. at 18 *with* Pl. Mem. at 66; State AG Mem. at 19 *with* Pl. Mem. at 66-67 n.44; State AG Mem. at 19-20 & n.10 *with* Pl. Mem. at 104-05 & n.58.)

The Attorneys General's assertion that "some significant role in the preparation or creation of a misstatement that is directly communicated to investors by another party can suffice for primary liability under either post-*Central Bank* test" (State AG Mem. at 10), is demonstrably inaccurate. As discussed in our opening brief (Citi. Mem. at 45-48), both the Second and Tenth Circuits have held that any statement giving rise to liability must be made *by the defendant* to give rise to liability after *Central Bank*. *Wright*, 152 F.3d at 175 (holding that "a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b)"); *Anixter* v. *Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) ("to 'use or employ' a 'deception' actionable under the antifraud law, [defendants] must themselves make a false or

misleading statement (or omission) that they know or should know will reach potential investors"); *accord Ziemba* v. *Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (rejecting substantial participation and adopting bright line). Indeed, as noted above, even the SEC's amicus brief rejects the Attorneys General's formulation. In any event, as discussed above and in our opening brief, the claims against Citigroup fail under either post-*Central Bank* test. (*See* pp. 26-27, above; Citi. Mem. at 44-50.)

IV.

PLAINTIFFS' CLAIMS UNDER SECTION 11 AND FOR CONTROLLING PERSON LIABILITY SHOULD BE DISMISSED

We showed in our opening brief that plaintiffs' claim against Citigroup under Section 11 of the Securities Act of 1933 based on its underwriting of 7% Enron Exchangeable Notes, fails for the reason that, among other things, plaintiffs do not and cannot satisfy the necessary element of reliance. (Citi. Mem. at 50-58.) Plaintiffs expressly concede in their response that they cannot satisfy this pleading requirement, and that they are therefore "not pursuing" their Section 11 claims against Citigroup. (Pl. Mem. at 3 n.8, 28 n.17.) Accordingly, this claim should be dismissed.

Finally, we also showed in our opening brief that plaintiffs' claims against Citigroup as a "controlling person" under Section 15 of the 1933 Act and Section 20(a) of the 1934 Act should be dismissed, because the complaint does not allege any facts showing that Citigroup had "control" over any other defendant. (Citi. Mem. at 59-60.) Plaintiffs have not responded to this showing, and accordingly these claims, too, should be dismissed.

CONCLUSION

For the foregoing reasons and the reasons given in our moving brief, Citigroup's motion to dismiss should be granted, and the complaint should be dismissed with prejudice as to Citigroup.

Respectfully submitted

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the above and foregoing instrument was this day forwarded via e-mail, facsimile, or overnight delivery to each of the counsel or parties listed on the attached Service List, pursuant to the Court's April 10, 2002 Order Regarding Service of Papers and Notice of Hearings.

Date: June 24, 2002

By: 
Jacalyn D. Scott
Eugene B. Wilshire

The Service List

Attached

to this document

may be viewed at

the

Clerk's Office